

STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION

CENTRAL ILLINOIS LIGHT COMPANY	)	
d/b/a AmerenCILCO	)	07-0585, 07-0588
	)	
CENTRAL ILLINOIS PUBLIC SERVICE	)	
COMPANY d/b/a AmerenCIPS	)	07-0586, 07-0589
	)	
ILLINOIS POWER COMPANY	)	
d/b/a AmerenIP	)	07-0587, 07-0590
	)	
Proposed general increase in rates for delivery	)	
service. (Tariffs filed November 2, 2007)	)	

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**REBUTTAL TESTIMONY OF CHRISTOPHER C. THOMAS  
ON BEHALF OF THE CITIZENS UTILITY BOARD**

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**CUB Exhibit 4.0**

**May 14, 2008**

**ICC DOCKET NO. 07-0585 (cons.)**  
**REBUTTAL TESTIMONY OF CHRISTOPHER C. THOMAS**

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1 **I. INTRODUCTION AND PURPOSE**

2  
3 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

4 A. My name is Christopher C. Thomas. My business address is 208 S. LaSalle Street, Suite  
5 1760, Chicago, IL 60604-1003.  
6

7 **Q. ARE YOU THE SAME CHRISTOPHER C. THOMAS WHO FILED DIRET**  
8 **TESTIMONY IN THIS PROCEEDING?**  
9

10 A. Yes.  
11

12 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

13 A. The purpose of my testimony is to respond to criticism of my Direct Testimony levied in  
14 the Rebuttal Testimony of Central Illinois Light Company d/b/a AmerenCILCO, Central  
15 Illinois Public Service Company d/b/a AmerenCIPS, and Illinois Power Company d/b/a  
16 AmerenIP (collectively “Ameren,” “the Ameren Illinois Utilities” or “the Companies”)  
17 witness Ms. Kathleen C. McShane, Ameren Ex. 22.0. I will also respond to portions of  
18 the Direct Testimonies of Staff Witness Janis Freetly, Staff Ex. 5.0, and Illinois Industrial  
19 Energy Consumers (“IIEC”) witness Michael Gorman, IIEC Ex. 2.0. In addition, my  
20 testimony identifies common themes that have emerged in the testimony filed thus far  
21 related to the appropriate ROE for the Ameren Illinois utilities.  
22

23 **Q. PLEASE SUMMARIZE YOUR FINDINGS.**

24 A. Ms. McShane has not provided any persuasive evidence to refute my conclusion that the  
25 Commission should reconsider its traditional cost of equity (also referred to as “return on  
26 equity” or “ROE”) analysis. As I explained in my Direct Testimony, current academic

research regarding the Capital Asset Pricing Model (“CAPM”) indicates that the Commission must carefully reevaluate the inputs it has traditionally accepted for the model and use it only as a check in determining a reasonable return for use in setting rates.

I continue to recommend that the Commission use the discounted cash flow model (“DCF”) to calculate the appropriate cost of equity for ComEd, and verify the results with a CAPM analysis performed using inputs consistent with the academic literature. Using this methodology, I continue to recommend an 8.955% cost of equity for the Companies’ gas distribution operations and a 9.046% cost of equity for their electric distribution operations.

## Electric Operations

### AmerenCILCO

	Amount	%	Cost	Weighted Cost
Long-Term Debt	\$ 141,064,013	34.336%	6.668%	2.289%
Short-Term Debt	\$ 15,865,875	3.862%	4.040%	0.156%
Preferred Stock	\$ 36,450,067	8.872%	5.335%	0.473%
Common Equity	\$ 217,459,214	52.930%	9.046%	4.788%
	\$ 410,839,169		<b>WACC</b>	<b>7.707%</b>

### AmerenCIPS

	Amount	%	Cost	Weighted Cost
Long-Term Debt	\$ 445,904,162	43.998%	6.538%	2.877%
Short-Term Debt	\$ 11,902,241	1.174%	4.010%	0.047%
Preferred Stock	\$ 48,974,984	4.832%	5.129%	0.248%
Common Equity	\$ 506,691,386	49.996%	9.046%	4.523%
	\$ 1,013,472,773		<b>WACC</b>	<b>7.694%</b>

## AmerenIP

	Amount	%	Cost	Weighted Cost
Long-Term Debt	\$ 704,808,159	34.456%	7.975%	2.748%
TFTN	\$ 171,533,494	8.386%	6.027%	0.505%
Short-Term Debt	\$ 47,106,782	2.303%	3.930%	0.091%
Preferred Stock	\$ 45,786,945	2.238%	5.010%	0.112%
Common Equity	\$ 1,076,286,905	52.617%	9.046%	4.760%
	\$ 2,045,522,285		<b>WACC</b>	<b>8.216%</b>

## Gas Operations

### AmerenCILCO

	Amount	%	Cost	Weighted Cost
Long-Term Debt	\$ 141,064,013	34.336%	6.668%	2.289%
Short-Term Debt	\$ 15,865,875	3.862%	4.040%	0.156%
Preferred Stock	\$ 36,450,067	8.872%	5.335%	0.473%
Common Equity	\$ 217,459,214	52.930%	8.955%	4.740%
	\$ 410,839,169		<b>WACC</b>	<b>7.659%</b>

### AmerenCIPS

	Amount	%	Cost	Weighted Cost
Long-Term Debt	\$ 445,904,162	43.998%	6.538%	2.877%
Short-Term Debt	\$ 11,902,241	1.174%	4.010%	0.047%
Preferred Stock	\$ 48,974,984	4.832%	5.129%	0.248%
Common Equity	\$ 506,691,386	49.996%	8.955%	4.477%
	\$ 1,013,472,773		<b>WACC</b>	<b>7.648%</b>

## AmerenIP

	Amount	%	Cost	Weighted Cost
Long-Term Debt	\$ 704,808,159	34.456%	7.975%	2.748%
TFTN	\$ 171,533,494	8.386%	6.027%	0.505%
Short-Term Debt	\$ 47,106,782	2.303%	3.930%	0.091%
Preferred Stock	\$ 45,786,945	2.238%	5.010%	0.112%
Common Equity	\$ 1,076,286,905	52.617%	8.955%	4.712%
	\$ 2,045,522,285		<b>WACC</b>	<b>8.168%</b>

**Amounts and costs of debt from Ameren Exs. 23.1. Cost of equity from CUB Ex. 1.0**

Additionally and at a minimum, I continue to recommend that the Companies' cost of equity be reduced by 67.5 basis points if proposed Rider VBA is approved for the Ameren Illinois Utilities gas distribution operations. I also continue to recommend that if proposed Rider QIP is approved for the Ameren Illinois Utilities electric operations, the Commission allow the Companies to recover only their embedded cost of long-term debt on projects financed under this rider, to adjust for the reduced risk the Companies have when making such investments.

**II. COMMON THEMES IN THE ROE TESTIMONY**

**Q. ARE THERE ANY COMMON THEMES IN THE ROE TESTIMONY FILED THUS FAR IN THE PROCEEDING?**

A. Yes. Staff Witness Janis Freetly, IIEC Witness Michael Gorman, and I all agree that analysts' growth expectations for companies in each of the various sample groups are not a reasonable proxy for sustainable growth into the indefinite future. ICC Staff Ex. 5.0 at 136-140 and IIEC Ex. 2.0 at 399 to 405. Ms. McShane does not disagree with this conclusion. Ameren Ex. 22.0 at 215-219. Unfortunately, any similarity in our positions ends there. Each witness has taken a different approach to deal with this problem. While the analyses of Staff, IIEC, and the Companies all rely in part on analysts' forecasts, my analysis rejects analysts' forecasts in favor of more reliable historic growth. As I have testified, this method is consistent with the academic literature and produces results that are unbiased by overly optimistic analyst estimates.

As Staff witness Freetly testifies, current analysts' expectations are unrealistic because they exceed the expected growth rate of the economy as a whole, and no company can reasonably be expected to sustain a growth rate greater than the expected rate of growth for the entire economy. As Ms. Freetly points out, in reality utility companies generally grow at even slower rates. Staff Ex.5.0 at 136-140. Accordingly, it doesn't make sense to assume that utilities can sustain growth that is greater than the overall economy.

However, Ms. McShane, Ms. Freetly, and Mr. Gorman all perform analyses that assume that utilities will grow at a rate equal to or greater than growth in the overall economy.<sup>1</sup> Ms. Freetly tries to justify this inconsistency by arguing that:

...while the overall economic growth rate may be biased upward for generally low-growth companies such as utilities, it is much closer to the growth rate that investors could reasonable expect utilities to sustain over the long term. Staff Ex. 5.0 at 190-193.

There is no basis to support such a contention. As I've testified, the best measure of growth is historic growth, not an unsupported assumption about future growth. Accordingly, the Commission cannot approve a DCF cost of equity that assumes growth at a level greater than that of the overall economy, and in fact it must recognize that growth for utility companies will actually be more in line with historical growth.

## **V. RESPONSE TO MS. MCSHANE**

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<sup>11</sup> The exception is Ms. McShane's DCF analysis for her gas sample which actually produces results of between 8.8 and 9.3%, which explicitly supports my 8.955% ROE estimate for the companies gas distribution operations.

85 **Q. HAVE YOU MS. MCSHANE’S REBUTTAL TESTIMONY, AMEREN EX. 22.0?**

86  
87 A. Yes. I have reviewed Ms. McShane’s Rebuttal Testimony and her attached exhibits,  
88 Ameren Exs. 22.0 and 22.1. Ms. McShane criticizes both my DCF and CAPM analyses,  
89 as well as my proposal to reduce the Companies’ ROEs if Rider VBA is approved. I will  
90 respond to each specific criticism in the following sections of my testimony.  
91

92 **III. A. RESPONSE TO CRITICISM OF MY DCF ANALYSIS**

93  
94 **Q. HOW DOES MS. MCSHANE RESPOND TO YOUR DCF ANALYSIS?**

95  
96 A. Ms. McShane raises four criticisms of my analysis at lines 399-427 of her rebuttal  
97 testimony:

- 98 • First, she argues that my use of historic internal growth rates over a specific  
99 period is a purely subjective choice, with no objective link to investor  
100 expectations.
- 101 • Second, she argues that my use of historic growth rates is inconsistent because  
102 companies in the sample earned returns above my recommended ROE.
- 103 • Third, she argues that my analysis fails to properly account for the declining  
104 dividend payout ratio.
- 105 • Finally, she argues that my internal growth analysis understates sustainable  
106 growth because it fails to incorporate external measures of growth.  
107

108 **Q. IS YOUR CHOICE OF HISTORIC INTERNAL GROWTH RATES PURELY**  
109 **SUBJECTIVE WITH NO OBJECTIVE LINK TO INVESTOR EXPECTATIONS?**

110  
111 A. No. There is a clear link between the growth rates that I used in my DCF analysis and  
112 objective investor expectations. Ms. McShane uses the term subjective to imply that my  
113 choice of growth rates is based only my own personal opinion, and that my choice is  
114 somehow in contrast to generally acceptable knowledge and justifiable belief. These  
115 contentions are both misleading and inaccurate.



As I demonstrated in my Direct Testimony, there is very clear evidence from well respected academic researchers that the best forecast of future growth is the historic average growth rate.<sup>2</sup> Others have shown that analysts' forecasts, which are already upwardly biased, become even more optimistic when there is uncertainty in the general economy, e.g. during the existing credit crisis:

... a large body of literature has examined the properties of financial analysts' EPS forecasts and the analysts' incentives to issue optimistic forecasts (Ali, Klein, and Rosenfeld, 1992; De Bondt and Thaler, 1990; and Diether et al., 2002). Ackert and Athanassakos (1997, 2003) show that analyst optimism and uncertainty are positively related. When there is a greater uncertainty about a firm's environment, analysts have fewer reputational concerns in issuing optimistic forecasts; analysts' forecasts tend to vary widely in this case. On the other hand, when the environment is quite certain, analysts are concerned about standing out of the crowd, and, hence, resist issuing optimistic forecasts.<sup>3</sup>

This information is widely available, which establishes a clear objective link to investors' expectations of growth and stock price. This link is solidified when investors, who expect growth at rates lower than analysts predict, buy shares of stock and bid the price up until it reflects the lower historic average growth rates that they expect. Though she does not specifically state it, Ms. McShane's statements could also be interpreted to imply that the time period I selected was subjective. However, my analysis

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<sup>2</sup> See also Eugene F. Fama and Kenneth R. French, The Equity Premium, 57 J. Finance 651 (April 2002).

<sup>3</sup> Athanassakos, George and Kalimipalli, Madhu, Analyst Forecast Dispersion and Future Stock Return Volatility, Quarterly Journal of Business and Economics, Vol. 42, Nos. 1 and 2, Winter/Spring 2003, pp 57-78, available at: [http://findarticles.com/p/articles/mi\\_qa5466/is\\_200301/ai\\_n21342367](http://findarticles.com/p/articles/mi_qa5466/is_200301/ai_n21342367).

141 is based upon historic average growth from 2002-2006, which was the most recent period  
142 for which complete data was available when I filed testimony. I chose 2002 as the first  
143 year of data because of the impact that the events of September 11, 2001 had on  
144 perceptions of risk throughout the general economy.<sup>4</sup> I believe this data appropriately  
145 reflects investors' expectations of future growth, because it captures the structural shift in  
146 perceptions of risk.

147  
148 **Q. IS YOUR CHOICE OF HISTORIC GROWTH RATES SOMEHOW**  
149 **INCONSISTENT BECAUSE THE SAMPLE COMPANIES HISTORICALLY**  
150 **EARNED HIGHER RETURNS THAN THE ROE YOU RECOMMEND FOR**  
151 **AMEREN IN THIS CASE?**

152  
153 A. No. There is no inconsistency in my recommendation, because there is no demonstrated  
154 relationship between returns that a company has earned in the past and returns that are  
155 expected in the future. The Nagel paper, which I referenced in my Direct Testimony,  
156 found that the forecast error inherent in historical average returns was so great the authors  
157 completely eliminated historic average returns from their analysis of predictive models.<sup>5</sup>

158  
159 Ms. McShane also made statements at lines 405-409 of her rebuttal testimony which  
160 imply that because Value Line is forecasting future earnings at a level above past  
161 achieved earnings, my recommendation is somehow inappropriate. However, as I  
162 discussed in my Direct Testimony, analysts' estimates are not accurate estimates of  
163 investors' expectations. And, as I discussed above, there is reason to believe that such  
164 forecasts are even more optimistic than usual given the current state of the economy.

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<sup>4</sup> For more information see Makinen, Gail, The Economic Effect of 9/11: A Retrospective Assessment, Report for Congress, September 22, 2002, at CRS-54 and CRS-55, available at: <http://www.fas.org/irp/crs/RL31617.pdf>

<sup>5</sup> Gregory L Nagel, David R. Peterson, and Robert S. Prati, The Effect of Risk Factors on Cost of Equity Estimation, Quarterly Journal of Business and Economics, Vol. 46 No. 1, 69.

165  
166 **Q. DOES YOUR DCF ANALYSIS PROPERLY ACCOUNT FOR THE DECLINING**  
167 **DIVIDEND PAYOUT RATIO?**

168  
169 A. Yes. Ms. McShane is incorrect when she argues that my analysis “failed to acknowledge  
170 that the dividend payout ratios have declined for both [my] samples during the 2002-2006  
171 period, and are expected to decline further.” Ameren Ex. 22.0 at 409-411. My analysis  
172 explicitly addressed this issue.

173  
174 As I discussed in my Direct Testimony, a declining dividend payout ratio means that  
175 earnings are growing more quickly than dividends. However, the DCF model uses only  
176 one measure of expected sustainable growth. Remember that the basic constant growth  
177 DCF formula is as follows:

$$k = D_0(1+g) / P_0 + g$$

179 Where:

180  $k$  = Investors required “rate of return”, or the “cost of equity capital”

181  $D_0$  = The current dividend payment

182  $g$  = The expected sustainable growth rate

183  $P_0$  = The current stock price

184  $D_0(1+g) / P_0$  = The expected dividend yield

185  
186 The  $g$ , or expected sustainable growth rate term, applies equally to both dividends and  
187 overall returns. This means that the model assumes the same rate for growth for both  
188 dividends and earnings. However, as Ms. McShane points out, analysts are expecting  
189 different levels of growth for both dividends and earnings. This means that using either  
190 the forecasted earnings growth rate or the forecasted dividend growth rate in the DCF  
191 would misstate the cost of equity, even if analysts’ forecasts weren’t upwardly biased as I  
192 have discussed.

I have proposed the Internal growth, or  $b \times r$ , method to correctly deal with this problem. The internal growth method looks only at the sustainable growth that a company can achieve without injecting more capital into the business. This is a necessary assumption because, although analysts are forecasting a changing dividend payout ratio, dividend growth is really uncertain.<sup>6</sup> This is why the DCF formula uses only the current dividend payment (increased by the expected sustainable growth rate), instead of some analysts' estimated or forecasted dividend payment. When combined with the fact that analysts' expectations of growth have been shown to be upwardly biased, the best measure of growth is the historic internal growth that companies in the sample group have actually experienced.

**Q. DO MEASURES OF INTERNAL GROWTH UNDERSTATE THE EXPECTED SUSTAINABLE GROWTH RATE?**

A. No. Ms. McShane is incorrect when she argues that my internal growth analysis understates the expected sustainable growth rate because I didn't consider measures of external financing, or external growth. Ameren Ex. 22.0 at 420-425. The internal growth method, sometimes referred to as the  $b \times r$  method, estimates the maximum level of growth that a company can sustain without injecting more capital. This assumption is completely consistent with the Commission's practice of granting regulated utilities a return on only their prudent and reasonably incurred investments. Evaluating external growth is a highly subjective exercise which produces results that are inconsistent with the Commission's practice of granting rates that allow the companies to recover their costs during the test year, including pro forma adjustments.

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<sup>6</sup> See Enrique Arzac, Valuation for Mergers, Buyouts, and Restructuring, John Wiley and Sons, 42 (2005).

Ms. McShane could also be implying that the cost of capital must be forward looking. A fact I do not disagree with. However, while Ms. McShane states that utilities “need to raise substantial amounts of capital in the future,” she has not shown that access to additional capital will somehow be impaired by looking only at historic internal growth. In fact, as I have testified, looking only at historic internal growth is the best measure of what investors expect for the future. Additionally, if the Commission approves the Companies’ Rider QIP proposal, the riskiness of future capital investments declines substantially, so the Companies will not be raising capital on the same terms that it has been in the past. This will reduce the Companies’ overall cost of capital, not increase it as Ms. McShane would have the Commission believe.

### **III. B. RESPONSE TO CRITICISM OF MY CAPM ANALYSIS**

#### **Q. HOW DOES MS. MCSHANE RESPOND TO YOUR CAPM ANALYSIS?**

A. Ms. McShane criticizes the methodologies that I used to estimate both beta and the equity market risk premium or (“EMRP”) which are the two primary drivers of CAPM results. Ameren Ex. 22.0 at 433-469. I will address each of her criticisms below.

#### **Q. WHAT IS MS. MCSHANE’S CRITICISM OF YOUR BETA ESTIMATE?**

A. Ms. McShane argues that my use of unadjusted beta parameters is inappropriate, and inconsistent with evidence that “raw” betas underestimate the returns of low beta stocks (less than 1.0) and overestimate returns of high beta stocks (greater than 1.0). Ameren

Ex. 22.0 lines 433-444. This argument misstates the facts, and misinterprets my testimony.

I testified that utility company betas do not trend toward 1.0, and that adjustments like those Ms. McShane seeks to justify therefore overstate beta parameters. In my Direct Testimony, I noted a well know study by Gambola and Kahl in 1990, which concluded that common adjustment factors inappropriately assume that the underlying mean of utility company betas is the market mean.<sup>7</sup> However, Gambola and Kahl found that this is clearly not the case. Therefore applying such an adjustment will overstate the beta estimate and therefore upwardly bias CAPM results. By calculating the average unadjusted beta for each sample group, my analysis determines an average beta estimate for a group of comparable utilities, which provides a much more objective measure of beta.

**Q. HOW DOES MS. MCSHANE CRITICISE YOUR EMRP ESTIMATE?**

A. Ms. McShane argues that “there is no convincing basis upon which to reject the historic risk premium as the best measure of investors’ equity return requirements.” Ameren Ex. 22.0 at 468-469. However, her contention reflects a misunderstanding of my testimony. The evidence that I cited was in fact predicated on the historic market risk premium. Ms. McShane is simply seeking to support only one narrow view of history, a view which has been found to be overinflated by the academic evidence:

Historical estimates found in most textbooks (and locked in the mind of many), which often report numbers near 8%, are too high

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<sup>7</sup> Michael J. Gambola and Douglas R. Kahl, Time Series Processes of Utility Betas: Implications for Forecasting Systematic Risk, Financial Management 92 (autumn, 1990).

for valuation purposes because they compare the market risk premium versus short-term bonds, use only 75 years of data, and are biased by the historical strength of the U.S. market.<sup>8\</sup>

Rather than rely on one narrow view of what the EMRP might be, my Direct Testimony avoided bias by examining evidence from the academic research, analysts' reports, and surveys of actual investors to conclude that investors expect an EMRP in the 3 to 5% range. This evidence has been summarized as follows:

We show that both the historic record, financial theory, and prospective estimates based on stock prices and growth expectations, all indicate that the future equity premium in developed capital markets is likely to be between 3 and 5%...<sup>9</sup>

**III. C. CRITICISM OF MY RECOMMENDED ADJUSTMENTS IF RIDERS ARE APPROVED**

**Q. HOW DOES MS. MCSHANE RESPOND TO YOUR TESTIMONY THAT THE COMMISSION MUST REDUCE THE AMEREN ILLINOIS UTILITIES NATURAL GAS RETURN ON EQUITY BY 67.5 BASIS POINTS IF RIDER VBA IS APPROVED FOR THE GAS DISTRIBUTION UTILITIES?**

A. Ms. McShane criticizes my testimony in four different ways. Ameren Ex. 22.0 at 471-549.

- First, she argues that because weather is a company specific risk it is not factored into the ROE produced by the CAPM.
- Second, she argued that any risk reducing benefits of weather protection are already captured by the sample group she selected for her analysis.
- Third, she argues that my analysis is flawed.
- Finally, she argues that my conclusion that risk reductions reduce ROEs is illogical.

**Q. IS IT RELEVANT THAT WEATHER, A DIVERSIFIABLE RISK, ISN'T FACTORED INTO A CAPM ANALYSIS?**

<sup>8</sup> Tim Koller et al., Valuation: Measuring and Managing the Value of Companies 306 (2005).

<sup>9</sup> Enrique Arzac, Valuation for Mergers, Buyouts, and Restructuring, John Wiley and Sons, 35 (2005).

298 A. No. In fact it only highlights my argument that the CAPM is not an appropriate model to  
299 estimate the cost of equity for a regulated utility. As my testimony demonstrates, weather  
300 has a significant impact on the variability of cash flows, which directly affects variability  
301 of returns to investors. More stable and certain cash flows will translate into increased  
302 confidence that investors will receive their required return. However, this decreased  
303 riskiness is not captured directly in the CAPM framework, and there is no way to reflect  
304 such known changes in risk into the CAPM. Of course, one might expect that beta  
305 estimates would decline over time as the utility became less risky than the overall market.  
306 As I testified in my Direct Testimony, I believe that the CAPM is of limited value in a  
307 regulatory framework.

308

309 **Q. DOES MS. MCSHANE’S SAMPLE GROUP ALREADY REFLECT THE “RISK**  
310 **REDUCING IMPACT OF WEATHER PROTECTION?”**

311

312 A. No. Ms. McShane has still not demonstrated that the Companies have accounted for the  
313 value of Rider VBA. As noted in my Direct Testimony, the Commission rejected a  
314 similar argument in the recent Peoples Rate case. The Commission reasoned that the  
315 Company’s witness did not quantitatively compare the sample companies’ weather  
316 protection mechanisms with the Company’s proposed rider VBA or examine the  
317 difference in each mechanisms’ operational characteristics. The same is true of Ms.  
318 McShane’s testimony in this case.

319

320

321 **Q. HOW DOES MS. MCSHANE ARGUE THAT YOUR ANALYSIS IS FLAWED?**

322



323 A. Ms. McShane provides a calculation which purports to show that replacing the 30 year  
324 normal customer usage used by the Commission to set rates during rate cases in 2002/03  
325 with 2006 test year average customer usage based on 10-year normal weather would  
326 result in an average decrease in ROEs of 64 basis points. She argues that this means that  
327 had Rider VBA been in place for the residential class, the Ameren utilities would have  
328 refunded money to customers, rather than increasing delivery rates, as their discovery  
329 response shows. Ameren Ex. 22.0 at 531-536. However, there are several erroneous  
330 assumptions in Ms. McShane's calculation that render it completely unreliable.

331  
332 First, she inappropriately assumes that the 2002-2003 rates would be set at 2006 test year  
333 levels. This assumption is illogical, inconsistent with the testimony of Ameren's own  
334 witness Mr. Charles D. Laderoute, Ameren Ex. 14.0, and of no use to the Commission.  
335 As Mr. Laderoute's schedule 14.3 demonstrates, there has been a marked decline in the 10  
336 year moving average of heating degree day data for central Illinois since the late 1990's.  
337 This means that using 10 year weather normals in 2002 would have resulted in per  
338 customer usage higher than the company has proposed in its 2006 test year. To assume  
339 that the lower 2006 usage levels approximate normals in 2003 makes little logical sense,  
340 and renders Ms. McShane's analysis useless to the Commission.

341  
342 Second, Ms. McShane fails to account for small commercial impacts of Rider VBA. The  
343 analysis in her workpapers focuses only on residential customers, but Rider VBA applies  
344 to both residential and small commercial customers, as did my initial analysis. By  
345 ignoring the commercial class, Ms. McShane's analysis is not comparable to mine.

346  
347 Third, there is significant upward pressure on the price of natural gas in the markets  
348 today. Average PGA prices so far for the Ameren Illinois Utilities in 2008 are between  
349 70 and 104% higher than they were for the year of 2002.<sup>10</sup> And, heading into the  
350 summer, prices are still increasing. The value of Rider VBA increases for shareholders  
351 significantly when this price pressure is coupled with the uncertainty in the general  
352 economy. For example, if prices continue to increase and the economy stagnates, causing  
353 a decline in customer incomes, it is reasonable to expect that customers will drastically  
354 cut back on their usage of natural gas. A study by the non-profit Rand Corporation found  
355 that in Illinois, customers respond to prices by reducing their consumption. This study  
356 found that, at a minimum, a 100% increase in prices would cause customers to reduce  
357 their usage by more than 6% in the short term and at least 4.7%. in the long term.<sup>11</sup> In  
358 this circumstance, the Company will be insulated from adverse impacts on their revenues  
359 due to the protection offered by Rider VBA, in fact as Mr. Brosch points out their  
360 revenues might even increase.

361  
362 The Commission simply cannot accept Ms. McShane's arbitrary and inaccurate portrayal  
363 of the effect that Rider VBA would have had in 2003.

364  
365 **IV. RESPONSE TO MS. FREETLY**  
366

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<sup>10</sup> See CUB's Natural Gas Price Checker at: <http://www.citizensutilityboard.org/pgs.php>

<sup>11</sup> Mark A. Bernstein and James Griffin, Regional Differences in the Price-Elasticity of Demand for Energy, Prepared for the National Renewable Energy Laboratory, 87-8 (2005)

367 **Q. STAFF WITNESS FREELY CRITICISES THE USE OF HISTORICAL DATA**  
368 **IN ESTIMATING THE COST OF EQUITY. STAFF EX. 5.0 AT 678-765. DO**  
369 **YOU AGREE WITH HER?**

370 A. In part. I agree with her conclusion that historical earned returns are a poor proxy for  
371 expected returns. Staff Ex. 5.0 at 723-737. However, the academic evidence that I have  
372 presented indicates very clearly that historical achieved growth rates are superior  
373 predictors of expected future growth.

374

375 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

376 A. Yes.